APPENDIX

FOMC BRIEFING - P.R. FISHER

JULY 5-6, 1995

Mr. Chairman:

Since your last meeting, there has been more volatility in short-term interest rates and less volatility in the dollar than were experienced during the previous months of the year. These somewhat different price movements both appear to reflect decreased risk appetites, and increased uncertainty, on the part of market participants.

Within the continued trend toward lower rates, the back-and-forth movements in June -- particularly in short-term rates and interest rate futures -- reflected the shifting implications of data releases and the alternating interpretations of comments by Committee members. With increasing uncertainty about both the direction of the economy and the likely course of the Committee's policy, market participants have traded the interest rate markets with increasing anxiety and decreasing conviction. The market's skittishness was most recently reflected in the abrupt back-up in rates following the release of new homes sales.

Because of the market's skittishness, I am reluctant to put too fine a point on what has or has not been priced into the market. While current prices of Fed Funds futures and Euro-dollar futures contracts are consistent with a 25 basis point ease by the end of the month and a greater than 50 percent probability of such a move at this meeting, I would caution against extracting such point estimate of market expectations. Indeed, I think that the 14 basis points of easing now in the July Fed Funds futures contract reflects a clearing price between a wide majority of market participants who do not, in fact, expect an ease at this meeting and a small number who have convinced themselves that the Committee will announce an ease in policy tomorrow.

With somewhat different consequences, the same lack of conviction is present in exchange markets. Following the concerted intervention on May 31st, the dollar traded uneventfully in narrow ranges against the mark and the yen, albeit gradually declining within those ranges.

Many market participants see the dollar as undervalued, and can find little to justify a further decline. But they also cannot see what will cause the dollar to appreciate. While the German and European economies appear to be slowing, and the Japanese economy and financial system appear to be in a dismal state, uncertainty about the U.S. economy makes it hard to see much upside for the dollar. In the short-run, day-by-day market participants see continued higher yields in European bonds and persistent dollar selling by Japanese exporters and Asian and European central banks as capping the dollar's upward potential and defining the upper end of the dollar ranges around 1.42 marks and 86 yen.

Last week the dollar experienced some choppiness and closed toward the lower end of its ranges, just above 1.38 marks and around 84 and a half yen. As a result of higher-than-expected preliminary German CPI for June, the market saw a decreasing likelihood of a Bundesbank rate reduction. The dollar moved up, following the announced resolution of the auto-trade dispute and then moved down after the Bundesbank's announced decision to leave rates unchanged and the new homes sales data. In my view, this back-and-forth of the dollar last week principally reflected the thinness of the market and the lack of conviction on the part of market participants.

In foreign operations, as I mentioned, the Desk sold 1 billion dollars worth of marks and yen on May 31st, evenly divided between the System and the ESF -- so for the System, we sold 250 million dollars worth of both marks and yen. This operation was undertaken at the initiative of the Treasury for the purpose of underscoring the April G-7 communique which sought an "orderly reversal" of recent exchange rate movements. With our support and that of the Bundesbank, the other G-10 central banks agreed to join the operation, which clearly surprised the market and helped to stabilize the dollar in the run up to the Halifax summit.

For value today, the Mexican authorities have drawn 2.5 billion dollars on the Treasury's Medium-Term facility. This brings to 10.5 billion dollars the total outstanding on the Medium-Term facility, with 1 billion dollars also outstanding on both the Treasury's and the System's short-term swaps. On August 1st, when the short-term swaps next mature, we expect to undertake the second of the agreed-three rollovers of the System's swap.

In domestic operations, actual reserve needs in the period were quite different from our initial forecast of a consistently growing and large reserve need. Demand for currency turned out to be much weaker than forecast and the generally-expected higher Treasury balances were more concentrated than anticipated. As a result, after an initial 4 and a half billion dollar bill pass on May 31st, temporary operations were adequate and effective in meeting the remaining need.

Looking forward, the combination of the weaker-than-expected demand for currency and the Treasury's monetization of 2.5 billion dollars of SDRs to fund the Mexican drawing, puts us in the posture of expecting to be draining reserves by the end of July.

Mr. Chairman, I will need separate votes of the Committee to ratify the Desk's foreign and domestic operations and I will be happy to answer any questions.

Michael J. Prell
July 5, 1995

CHART SHOW PRESENTATION

We're going to employ the tag-team approach this afternoon. I'll commence the presentation with a brief overview of the staff's economic projection. Then, my colleagues, Tom Simpson, Larry Slifman, and Karen Johnson, will address some issues that we thought might be of particular interest to the Committee. I'll wrap up by unveiling the forecasts you submitted for inclusion in the Board's Humphrey-Hawkins report.

Chart 1 starts things off by summarizing some of the key things we know about where the economy has been recently. As we noted in the Greenbook, while there's a consensus among analysts that activity slowed a lot during the second quarter, not everyone has marked GDP growth down as low as the minus one-half percent we've estimated. The data for the period are still far from complete, so we could not argue vigorously for our less optimistic view. Be that as it may, what ultimately swayed us in our assessment was the softness in labor market indicators--most notably the drop in production worker hours through May, at the left. Although initial claims for jobless benefits, shown at the right, have not risen to a level that we would think consistent with outright declines in employment, we hesitated to discount the reported slide in hours any more heavily than we did.

The remaining four panels highlight the sectors of expenditure for which we have two months of data. As you can see at the middle left, real consumer spending rose smartly in May. However, given the weak start in April, it would take another large gain in June to produce more than a mediocre quarterly average increase. And, though the May burst of new home sales, shown at the right, bodes well for future building activity, the descent of single-family starts into the spring months guarantees that residential construction will contribute a hefty negative in second-quarter GDP. In the lower left panel, new orders for nondefense capital goods have been very choppy of late; and, while shipments are up substantially, other data on aircraft and motor vehicles suggest that the second-quarter gain in overall equipment spending may be less than half that recorded in the first quarter. Finally, at the right, nonresidential construction fell off in the latest month and appears likely to record a less than spectacular quarterly rise. Unfortunately, we have only one month's full data for the volatile inventory and net export components of GDP, so there's plenty of room for surprise in the second-quarter GDP picture. Thus, I would emphasize, again, the tentativeness of our current estimate.

Turning now to the outlook for coming quarters, Chart 2 summarizes the monetary and fiscal features of our forecast. As you know, we based our forecast on the arbitrary assumption that the federal funds rate will be held at 6 percent into early 1996; we assumed that it would then drift down a half percentage point, given the slowing of inflation we expect to occur in the period ahead and an allowance for effects of ongoing fiscal restraint on the trend of the "natural" real rate of interest in the economy.

In long-term markets, we've predicted that the assumed failure of the Fed to ease and incoming evidence of a pickup in activity will push bond yields appreciably higher by year-end--and that there will be only a partial reversal of that back-up during 1996.

We believe that the economy has received a boost over the past couple of years from a swing toward easier credit availability and more lenient loan terms; we are anticipating that lenders will become more cautious in coming quarters, but only mildly so.

Meanwhile, apart from a slight firming in the near term in response to the projected rise in bond yields, we anticipate that the foreign exchange value of the dollar will be little changed through 1996.

One factor that obviously could play a role in shaping developments with respect to interest and exchange rates is fiscal policy. The outlook for the federal budget is highly uncertain. We share the oft-expressed sentiment that the prospects for deficit slashing seem greater now than they did a few months ago. However, we don't think it will be at all easy to convert the congressional budget resolution into specific bills that the President will sign or that have will such broad support as to be veto-proof. In the end, it seems likely that, if there is to be a budget, there will have to some serious compromising. As you can see in the bottom panel, our assumed fiscal '96 and '97 deficit reductions of $30 and $25 billion, are smaller than those contained in the budget resolution--at least before the Congress tacks on any tax cuts, which have yet to be spelled out. On the other hand, our deficit reduction is much more sizable than that recommended by President Clinton. We've anticipated that cuts in purchases will be modest, and that it will be transfers and grants that provide the bulk of the deficit-reduction. We've included a tax cut, in the form of a credit for children.

Chart 3 describes, in broad terms, how we think the economy will evolve against this backdrop. GDP growth, the red line in the top panel, outstripped final sales last year, as inventory investment shot up. As expected, that pattern seems to be reversing this year.

The GDP growth rates of 1-3/4 percent in 1995 and and 2-1/4 percent in 1996 are both below what we've assumed to be the trend rate of expansion of potential output, which is about 2-1/2 percent. Consequently, pressures on resources should diminish. As the middle panels indicate, we are projecting that the unemployment rate will inch back above 6 percent, while the rate of factory use is expected to drop to below its longer-term average of 81.3 percent.

With this decline in resource utilization, consumer price inflation should ease back after the bulge earlier this year. We expect that both the overall and core CPIs will be edging south of 3 percent again by 1996.

Chart 4 sketches out the projected movements of the major components of GDP. I perhaps should note that we haven't updated these graphs to reflect the revisions in the first-quarter GDP data released last Friday, but those changes were small. As you can see in the upper-left panel, we believe that inventory investment probably slowed in the second quarter and will slow further in the third. By the end of the summer, stocks should be in reasonable alignment with sales, and the resumption of moderate accumulation will contribute to an acceleration of GDP in the fourth quarter.

This all hinges, of course, on the vitality of final demand. One key ingredient here is the response of housing to the large decline that has occurred in mortgage rates. Even discounting last week's figure on new home sales considerably, the prospects appear good for achieving at least the upturn in residential investment that is graphed at the right.

With an improvement in the housing sector, we would expect demand for furnishings and appliances to firm. But, as you can see in the middle-left panel, the trend of disposable income growth is now slowing, in line with the weaker pace of hiring, and so we're looking for only a limited rebound in the growth of personal consumption expenditures in coming quarters.

We expect that there will be a further deceleration of business fixed investment over the second half of this year--one that is most marked for producers' durables--the red bars--but that also encompasses nonresidential structures. A moderate step-up in equipment spending is forecast for next year, as firms respond, with the usual lags, to the firming in product demand and the lower level of capital costs.

Government purchases will be sluggish, under our fiscal assumptions. Not only will the deficit-reduction effort push federal purchases down at a faster rate, but the reduction in grants will intensify the pressures on states and localities to trim the growth of their outlays for goods and services.

Finally, a strengthening of foreign growth should combine with the depreciation of the dollar we have already seen to produce a more rapid expansion of exports over the forecast period. With imports also being sucked into the U.S. at a substantial clip, though, net exports will rise only marginally. Still, this will be a far more favorable contribution to GDP than the sizable negatives that we've seen over the past few years.

I've obviously given only a broad-brush treatment to our projection--and much of that admittedly repeats what you've read in the Greenbook. My colleagues now will attempt to add some value in this presentation. Tom will start by fleshing out some of our thoughts on the financial setting for the economy; Larry will focus on some of the more interesting questions relating to the outlook for private spending and for inflation; and Karen will address some issues pertaining to the prospects for the dollar and for the economies of some of our key trading partners.

Thomas D. Simpson
July 5, 1995

In my comments on the financial setting for the staff economic forecast, I will focus on: developments on the credit availability front; the healthy gains in stock prices thus far in 1995 and whether this represents formation of a "bubble;" and the level of real interest rates as we enter a period of greater fiscal restraint.

Charts 5 and 6 address credit availability. The upper panel of chart 5 shows that bank capital positions remain quite comfortable by the standards of recent decades, having climbed a good bit from the period of asset quality concerns of the late 1980s and early 1990s. In the context of stronger capital positions, banks have become willing lenders. Indeed, the center panel shows that the margin of banks more willing to make business and consumer loans has remained sizable over the first half of this year. In the case of business loans, this greater willingness seems to importantly reflect a relaxation of the very stringent standards imposed several years ago, an observation generally confirmed by examiners.

Consistent with the willing posture of loan officers, spreads on business loans, represented by the red line in the bottom panel for small business loans, have been on a mild downtrend over the past couple years. Auto loan spreads have widened some in recent months but from unusually low levels, as auto loan rates have in fairly typical fashion lagged market rate declines, and they remain below levels of the early 1990s.

Spreads on open market business debt, shown at the top of your next chart, have risen some of late as the bond market has absorbed larger volumes while the paper market perhaps has been affected by some quarter-end pressures. On balance, though, they remain fairly tight.

Meanwhile, the dramatic improvement in credit quality in the consumer and business sectors seems to have come to an end. The red line in the middle panel shows that consumer loan delinquencies appear to be turning up from very low levels, in keeping with the recent upturn in debt-service burdens, the black line. Looking forward, the staff forecast implies that household debt-service burdens rise further, as shown by the broken line, and thus it seems reasonable to expect further increases in delinquencies.

The bottom panel shows net interest payments of nonfinancial corporations in relation to cash flow, along with the delinquency rate on business loans. Interest payments began rising last year but remain relatively low and, in the staff forecast, they edge down after midyear. Accordingly, while the delinquency rate on business loans likely will move higher in coming quarters, the increase should prove modest.

On net, these considerations suggest that lenders will be turning more cautious and credit will become less available. However, should income and interest rates unfold in line with the staff forecast, any such move to stringency will be mild, exerting only a slight drag on spending.

The tremendous run-up in stock prices this year to even higher records has raised concern about whether a "bubble" might be developing in this market and whether an easing of policy at this time might foster further speculative behavior. Chart 7 illustrates that share prices have risen about 17 percent over the first half of this year, a period in which analysts have generally been surprised on the upside by earnings reports. Spikes of that magnitude typically have not persisted for long, although they typically have not been reversed immediately and they have not been harbingers of recession. The center panel shows that economic profits, despite some leveling out of late, were up nearly 25 percent in the first quarter from two years earlier, and the broken line shows that the staff forecast looks for a resumption of profits growth later this year.

In the bottom panel, the red line charts the S&P dividend price ratio and shows that the current dividend yield is very low historically. Moreover, real bond rates, which I will be discussing shortly, may be a little on the high side of historical norms, despite sizable declines over recent months, a factor that might call for higher dividend yields. However, dividend pay-outs for these firms have been extremely low, as an unusually large number of corporations have favored retained earnings to finance fixed investment or to buy back shares when it was thought that the potential returns on internal investments were inadequate. Indeed, as the black line illustrates, the earnings-price ratio, using earnings measured on a trailing basis, has been rising this year, and its level is not particularly low--that is, the P-E ratio is not particularly high.

On balance, there are no strong reasons to believe that, in the context of the staff economic forecast, recent gains in stock prices are unsustainable. However, the risks in the near term may be greater on the downside, especially since analysts appear to be more optimistic than the staff about the outlook for profits, and we have interest rates going up, which does not appear to be built into the market.

Turning to real interest rates, the upper panel of chart 8 plots measures of the real rate on federal funds and the key ten-year Treasury note since 1960. By the standards of this long period, the current 3 percent real federal funds rate is a bit on the high side of historical experience. The longer-term real rate has fallen a good bit this year but it, too, remains above longer historical averages. By the standards of the past decade and a half, though, both real short and long rates are moderate. In any event, judging whether real interest rates are restrictive or not at any point in time depends importantly on other forces acting on the economy, such as private propensities to spend, exchange rates and foreign output, and fiscal policy.

Of particular interest at the present time are impending deficit-cutting measures as both the Congress and the President have embraced proposals that they claim will result in a balanced budget. The middle panel puts the deficit scaled by GDP in historical perspective. Even though the deficit is down appreciably from the swollen levels that characterized much of the 1980s and early 1990s, it is still large by historical standards. As shown in the inset to the left, absent bold fiscal action, the deficit would tend to widen some in the years immediately ahead, as shown by the red line labeled "baseline" which is based on the CBO's "current law" baseline. In contrast, the blank line labeled "balanced budget" is a staff translation of Congress's recent budget resolution geared to budget balance in the year 2002.

One way to assess this and other developments bearing on equilibrium real interest rates is through an econometric model like the staff's. Such an exercise is shown in the bottom panel. In essence, the experiment performed involves selecting the real federal funds rate path that results in output moving in line with potential and stable inflation. A word of caution at this point is that exercises of this sort should be regarded as illustrative and not read too literally: Apart from all the uncertainties about behavioral relations in the model, the particular results depend on various assumptions.

The red line, labeled "baseline," corresponds to the baseline deficit shown in the center panel and should not be confused with baseline strategies shown in the Greenbook and Bluebook. Under this baseline, the real federal funds rate would remain in the 3 percent area, buoyed by continued large fiscal deficits. The solid black line illustrates the path of the federal funds rate required under the balanced budget scenario, based on the assumption that the bond rate, which plays a critical role in this model, responds primarily to current and past levels of short-term rates--that is, the process determining the bond rate is adaptive or backward looking. In these circumstances, the funds rate would need to drop promptly, given lags, by about 3/4 percentage point or so to avoid a weaker economy once spending cuts begin to kick in later this year. This new lower level would need to be held for a couple years before it would have to drift down about another 1/2 percentage point to counter the mounting drag from ongoing deficit reduction.

Of course, the bond market might be more forward looking. Indeed, it has already built in some deficit reduction, a factor that has contributed to the bond market rally over recent months. This will act to cushion the depressing effects on the economy of impending budget cuts. The broken black line illustrates the path that the real federal funds rate would need to take, in the eyes of this model, if the move to a balanced budget were fully credible to market participants and current bond rates accurately reflected the future path of the federal funds rate needed to achieve the same outcome as in the other two simulations. In these circumstances, no reduction in the real federal funds rate would be necessary for some time, until the turn of the century, as prompt, forward-looking bond rate declines provide sufficient stimulus to rate-sensitive sectors to offset weakness coming from fiscal restraint. Eventually, the real funds rate would need to decline, converging toward the level in the adaptive expectations case and validating expectations.

Clearly, both the backward-looking and fully forward-looking paths represent extremes. In any event, the somewhat forward-looking nature of the bond market implies that recent rate declines are, to a degree, reducing the need for aggressive policy measures in the quarters ahead.

Your next chart focuses on the current inventory correction. To give you the bottom line of our analysis first, we do not think inventory overhangs are widespread; primarily they are confined to autos and some suppliers such as steel, housing-related items, and apparel. Producers in these sectors have been prompt to cut output, and with demand showing signs of firming, we think the process pretty much should have run its course by the end of the third quarter.

Turning to the specifics, the upper left panel shows the sharp run-up in dealer inventories year earlier this year. As you know, automakers responded by slashing production in the second quarter. Sales picked up in May--bolstered at least in part by manufacturers' incentives-- and if, as we expect, they climb a bit further during the summer, the current level of production should bring stocks close to the 60-day industry norm by September.

Outside of motor vehicles, significant inventory overhangs appear to be limited to only a few sectors of the economy. I use the phrase "appear to be", in part, because monthly inventory data are subject to sizable revisions that sometimes can substantially alter analytical conclusions. That said, the data--shown in the middle panel--and anecdotal reports suggest that stocks are most out of kilter in areas related to the softness in the housing market: construction supplies, and home goods such as appliances and furniture. In addition, apparel inventories are reported to be excessive. The stock-sales ratio for these market groups is shown by the red line.

Elsewhere, as shown by the black line, stocks in the aggregate have edged up much less relative to sales. The lower left panel illustrates that manufacturers of construction supplies, home goods, and apparel responded promptly to the recent inventory accumulation, and have cut production nearly 4 percent since January. We expect that the inventory correction in these sectors will be completed during the next few months through a combination of some further production adjustments and a strengthening of demand. One tentative sign of that strengthening was the May rise in new orders received by these manufacturers--the lower right panel.

As Mike noted, in our forecast, a critical element in containing the size and scope of the current inventory adjustment is a projected firming in consumer demand--the subject of your next chart. In making this projection, we first had to ask ourselves why PCE has been so sluggish in recent months. We noted in the Greenbook a variety of possibilities. Among them, the exhaustion of pent up demand doubtless has played an important role.

As shown in the upper left panel of chart 10, during 1992, 93, and 94, real outlays for consumer goods grew rapidly: indeed, at nearly twice their longer-run average pace. It is probably the case that the slowing of spending during the first half of this year reflected, at least in part, the typical consumer "breather" that often follows a period of rapid spending to above trend levels. If this analysis is correct, we should begin to see a pick up, albeit limited, in consumer spending.

For motor vehicles, the average age of the nation's auto fleet, shown in the upper right panel, has been trending up and now is at its highest level since the late 1940s. In light of the aging of the stock, we expect replacement demand to continue to boost sales over the next year and a half. In addition, if housing activity picks up as we are projecting, consumer spending for furniture and appliances also should strengthen.

In the Greenbook we noted that several of the fundamental determinants of consumption activity are still at favorable levels. Among them is unemployment expectations, the black line in the middle panel, which statistically seems to be a useful indicator of consumers' willingness to purchase autos and other durable goods. Given our forecast of sustained growth and only a small rise in the jobless rate over the next year and a half, we don't expect much deterioration in these expectations, which suggests that spending should hold up well as a share of income. In addition, the recent stock market rally has added several hundred billion dollars to household net worth, the black line in the bottom panel, reversing much of the previous dip. Over the long run, net worth and saving are inversely related, as theory would predict, although in the short run the relationship is much less tight. Nonetheless, last years' flat stock market and declining bond prices may have been a damping influence on consumption during the first half of this year, while in the projection, we see the recent rise in securities prices pushing the saving rate a bit lower than it otherwise would be.

Another important issue in the forecast is how much longer the boom in equipment spending can be sustained--your next chart. We expect real outlays for producers' durable equipment to grow at more than a 5 percent annual rate over the next year and a half. Coming on top of the double-digit growth rates for equipment spending during the past three years, one would think the current investment boom should be off the charts compared with previous cyclical expansions, and that a major contraction may be imminent. But, as shown in the upper panel, using a quantity index that is less distorted by the relative decline in computer prices over time, the current cycle is well within the range of previous long-expansion experience.

One problem with this cyclical comparison is that, over the years, equipment investment has switched toward capital goods that depreciate more rapidly, such as computers and communications equipment. Because of the higher depreciation rate, firms have to "run faster" just to stay in place. To adjust for this, the middle panels look at <u>net</u> investment relative to the net capital stock--that is, the growth rate of the net capital stock. Because of the dramatically different investment rates for computers and other PDE, they are shown separately. In both cases, the capital stock is growing rapidly, but not out of bounds by historical standards.

One negative factor in the outlook for equipment spending is our projected decline in capacity utilization--the lower left panel. Clearly, if firms find that they have too much idle equipment, they will re-think their plans to replace or upgrade, let alone expand, existing capacity. This has led us to keep the level of spending for equipment other than computers essentially flat over the projection period. In contrast, the cost of capital relative to the cost of labor--the lower right panel--continues to fall rapidly, primarily reflecting further declines in computer prices. On balance, we expect investment in computing equipment should remain on a rising trend, although slower than its recent torrid pace, keeping overall PDE growing at a respectable rate.

Your next chart examines our inflation forecast in greater detail. Basically, the issue is: why, in contrast to many outside forecasts, do we think inflation is likely to subside from the 3-1/2 percent rate observed so far this year, to a shade under 3 percent next year? In part the acceleration of consumer prices in the opening months of this year has reflected higher materials costs and rising non-oil import prices--the middle panels. Some additional pass-through may still be in the pipeline. But we expect those effects to wane soon. The PPI for intermediate materials excluding food and energy rose only 0.2 percent in May and, with manufacturing activity contracting, spot prices for many industrial commodities have stabilized or even fallen recently. Moreover, the dollar is expected to be little changed during the projection period, and this should keep import price increases in check, following the recent surge.

Labor cost trends have been quite favorable recently. Over the four quarters ending in March, productivity in the nonfarm business sector increased 2 percent while hourly compensation was up only 3 percent. As shown in the lower panel, much of the moderation in compensation over the past two years has come from a pronounced slowing in benefit costs--much of it related to health care costs. Health insurance premiums rose only 1-1/2 percent over the past year, while the costs for workers' compensation plans, which are partly related to medical inflation, actually fell. In addition, employer pension contributions slowed abruptly in the first quarter. Some of these improvements in benefit-cost inflation reflect one-time savings and we expect some bounce-back in the growth of benefits next year. In addition, with resource utilization rates expected to remain fairly high, we are projecting some upward pressure on the growth of wages and salaries.

On balance, we are forecasting hourly compensation to rise at a 3-1/4 percent rate through the end of next year--only a quarter of a percentage point faster than during the past year.

Karen will now continue our presentation.

Karen Johnson
July 5, 1995

As Mike has explained, I will consider issues underlying our thinking on the dollar and some elements in our outlook for key U.S. trading partners.

Chart 13 shows recent developments in dollar exchange rates. In terms of the currencies of the other G-10 countries, the dollar has generally been declining during the first half of this year in both nominal terms, not shown, and price-adjusted terms, the red line in the top panel--continuing a longer trend of dollar depreciation that began in early 1994. Economic developments during much of 1995 have worked to lower jointly the real long-term interest differential, the black line, and the price-adjusted value of the dollar. With respect to the individual G-10 currencies--the lower left panel--movements of the dollar to date this year have differed substantially, reflecting the differing factors that lie behind the changes in bilateral dollar rates. For example, the persistent trade dispute between Japan and the United States--and their respective trade imbalances--weighed on the yen/dollar rate, and it is against the yen that the dollar has depreciated most--15 percent--since December. Of the European G-10 currencies, the dollar has fallen least against the Italian lira and the British pound. The dollar fluctuated in terms of the Canadian currency during the past half year, often moving in the opposite direction from its change with respect to the other G-10 currencies, but on balance, there is now little change from December in the bilateral Canadian dollar rate.

In contrast to its movement against G-10 currencies, the dollar has appreciated strongly in terms of the Mexican peso, shown in the lower right, since the eruption of the crisis in Mexico last December. At first, the dollar's sharp appreciation in nominal terms, the black line, resulted in real dollar appreciation, the red line, as well. Subsequently, as Mexican consumer price inflation rose in response to the exchange rate shock, the real appreciation in the peso/dollar rate began to retreat. We expect the nominal peso/dollar rate to move up a bit further over the forecast period, but continued high, though slowing, Mexican inflation should result in less real appreciation of the dollar in terms of the peso, on balance, by the end of 1995 than we see now. I shall return to the implications of developments in Mexico for the U.S. economy shortly.

Chart 14 contains one development common this year to almost all the G-10 countries, including the United States: lower nominal interest rates, particularly long-term interest rates, shown on the right. The numbers in the tables in the middle panel show that on average U.S. short-term rates, on the left, are above foreign rates and have not fallen as much as those abroad. Just the opposite is the case, however, for long-term rates, on the right. Japanese long-term rates have come down the most, but the decline in U.S. rates noticeably exceeds that of foreign rates on average. Our forecast is for long-term rates abroad to change little from current levels over the rest of this year and next. In that event, the dollar can be expected to retrace some of its decline, as somewhat higher projected U.S. long-term rates move the interest differential over the next few months in favor of dollar assets; the dollar would subsequently remain little changed over the rest of the forecast period.

Of course, other factors can influence exchange rates as well. Two that are particularly relevant now are listed in the lower left: U.S. fiscal policy and the long-run outlook for our current account balance. As market participants associate less risk with the long-term outlook for fiscal policy, perhaps in response to perceived progress on the budget in Congress and with the Administration, they may in the near term also have a more favorable view of the dollar, causing it to rise. Over a somewhat longer perspective, adjustment within the economy to a sustained lower fiscal deficit is likely to be associated with lower real interest rates and some decline in the dollar's spot exchange value that would induce some of the resources no longer consumed in the public sector to move into the traded goods sector.

Continued current account deficits also pose a risk to the dollar. Our econometric models based on post-war experience suggest that our external deficit would expand further over the medium term at current exchange rates. If market participants came to see the external deficit as implying ever higher U.S. net indebtedness to the rest of the world as a share of GDP, they would put downward pressure on the dollar. Arguing against widening deficitis is the fact that U.S. unit labor costs in manufacturing, at current exchange rates, are well below those of our major industrial trading partners, as can be seen on the right. It may be that our econometric models do not incorporate sufficiently this competitive edge on the production side. A more favorable trade outcome would eliminate the hypothesized downward pressure on the dollar. The exchange markets will bring forward into current rates the expected outcome of these longer-term developments, but to what extent is difficult to anticipate--adding some uncertainty to our outlook for the dollar.

Your next chart presents an overview of the foreign outlook for real growth. As you can see in the top left, we expect that growth in our trading partners, weighted by U.S. non-agricultural exports, fell sharply during the first half of this year from the robust growth rate of 1994. Through the end of 1996, we expect to see foreign growth recover somewhat and continue to outpace growth of U.S. real GDP. The top right box shows the critical role of the Asian developing countries in sustaining growth of foreign output, particularly in 1995. We expect that 1996 will see improvement in the industrial and, especially, the Latin American countries.

The middle left panel provides an insight into the relative importance of these regions for U.S. exports and output. The industrial countries account for more than half of U.S. exports, and Canada by itself is particularly important. Latin American and Asian developing countries each have a significant share. Details of the forecast for the foreign G-7 countries, Mexico, and the Asian developing countries are shown on the right. For the foreign G-7 countries, the slowdown in the first half of this year is concentrated in Canada and Japan. For the developing countries, weakness is most pronounced in Mexico.

The lower panels summarize our estimate of the impact of developments in Mexico on the U.S. economy and our outlook for Mexico and the other Latin American countries. Data already available confirm an extremely sharp drop in Mexican real output during the first quarter that accounts for much of the projected 1995 decline shown in the chart on the left.

The first-quarter decline in large part results from the policy measures adopted by the Mexican officials and the impact of the depreciation and rise in peso interest rates on Mexican consumer and business confidence. We expect that by the end of this year real output will no longer be falling, and we look for Mexican growth to resume next year. Some slowing of output growth in other Latin American countries, particularly Argentina, reflects spillover effects of the Mexican crisis into asset markets and on macroeconomic policies.

On the right, our projection for the U.S. trade balance with Mexico under current assumptions for Mexican real growth, prices, and the exchange value of the peso is compared with our projections last December. We expect that the bilateral balance for goods and services excluding oil will fall from a small surplus last year to a deficit of $15 billion by the end of this year, a bit larger next year. Data for merchandise trade through April, the line, suggest that such a substantial turnaround in the trade balance with Mexico is already well underway. The severe decline in Mexican output that has occurred largely accounts for the speed with which U.S. trade with Mexico has adjusted. Looking ahead, real depreciation of the peso will help maintain a surplus for Mexico as positive real output growth returns in 1996. With the adjustment of our trade balance with Mexico largely behind us, an important negative influence on the change in U.S. net exports and activity during the first half of the year will have ended.

Chart 16 addresses in more detail our outlook for the major European industrial countries and Canada. Recent exchange rate movements are likely to affect the pattern of growth in Europe, particularly this year. The top left panel groups Germany and France, two countries with relatively strong currencies, and compares them with the United Kingdom and Italy, two countries whose currencies depreciated substantially in 1992 and then fell somewhat further again this year. For example, the weighted-average value of the mark, on the right panel, has appreciated during this year to peak values for the floating rate period while the pound has fallen somewhat from the level it maintained in 1993-94. In both pairs of countries, growth is expected to slow noticeably this year from the robust pace last year. We project some boost to growth this year for the United Kingdom and Italy from their external sectors while in Germany and France net exports will contribute little. However, despite the near-term slowing, for all these countries growth is expected to average about 3 percent over the rest of the forecast period, moving these economies by the end of 1996 close to our estimates of their respective levels of potential output.

In contrast, real output growth in Canada fell drastically in the first half of the year and is expected to revive only to about 2-1/2 percent over the next six quarters--well below last year's rate. The Canadian outlook in part reflects the slowing to date of output growth in the United States and the weak projection for the current quarter. In addition, both monetary and fiscal policy in Canada were tightened in 1994. The panel on the right shows the upward movement in the Canadian overnight rate of nearly 450 basis points, on balance, since the beginning of 1994. While the Bank of Canada has begun to ease that rate back down, it remains quite high. In addition, the Canadian government has injected greater fiscal restraint this year and last. The structural budget deficit over this time is estimated to have contracted by about 1-1/2 percentage points of GDP. As a consequence of the lags with which these policy actions have their effects, we expect Canadian real output growth to remain subdued over the forecast period. We were surprised, however, as were most analysts, by the extent of slowing that occurred in the first quarter, when real output grew less than 1 percent at an annual rate. Some of this deceleration may subsequently be revised away or reversed in later quarters, but there is clearly some risk that such an abrupt drop, which was moderated only by large inventory accumulation, could be a harbinger--or could precipitate--even weaker growth than we are forecasting.

Your next chart presents the elements of our thinking about the outlook for the Japanese economy. As shown in the upper left, we look for real growth in Japan to begin to strengthen during the second half of this year but to remain subdued through the forecast period. The strength of the yen is a major factor restraining expected Japanese growth. However, for some of the other Asian countries, appreciation of the yen in terms of their currencies will boost exports so that growth in the Asian developing countries is expected to continue strong, although it will slow a bit from its very high rate in 1994.

As can be seen in the right panel, Japanese growth of around 2 percent per year is not sufficient to narrow the gap between actual and potential output, and we project a widening in that gap through the end of next year. The low level of resource utilization in Japan and the appreciation of the yen have contributed to deflation in goods prices. The lower left panel shows the changes over the preceding twelve months for two major components of the consumer price index, services less rent and goods less food, and for the producers' price index. Inflation in the price of services, which are domestically produced and for the most part do not compete directly with imports, has been between 1 and 2 percent over the past year. However, prices of goods have actually been falling for some time. This deflation is not limited to imported final goods, but likely does reflect the influence of competing imported goods and the falling prices of imported inputs.

The panel on the right shows that critical asset prices--those for stocks and for land--are also falling in Japan--as they have been for some time. The continuing decline in land prices has added to the woes of the Japanese banking system and risks increasing the already large burden of nonperforming loans. Lower land prices reduce further the value of collateral behind real estate loans on the books of the banks, already a much-troubled portion of banks' portfolios. Further declines in stock prices would lessen the market value of the hidden reserves of the banks and so reduce the capacity of Japanese banks to finance additional loan loss from hidden reserves. While these problems have been acknowledged for some time by Japanese authorities, progress in terms of improving banks' balance sheets has been limited. Continued declines in these asset prices add to the perceived risk of a banking crisis in Japan. At the very least, it appears that Japanese banks are not in a position to be particularly supportive of the recovery of economic activity.

Without any foreseeable pressure on resource availability soon and with asset prices and goods prices falling, easing by the Bank of Japan would seem warranted. In our forecast we have assumed a small further reduction in the call money rate, but no discrete easing move, such as a discount rate cut, by the Bank of Japan. While we are forecasting some recovery in real growth in Japan, without even greater impetus from monetary policy or additional fiscal stimulus, there is downside risk of a return to recession in Japan in our outlook. Indeed, Governor Matsushita, in his press conference today following the Bank of Japan's branch managers' meeting, suggested that a discount rate cut is under consideration.

Mike Prell will now present the committee's forecast.

Michael J. Prell
July 5, 1995

To wrap up quickly, let me just draw your attention for a moment to the last chart, which summarizes the forecasts you submitted. You've lowered your sights considerably for real GDP growth this year, with the central tendency now bracketing the staff forecast, at 1-1/2 to 2 percent. The silver lining in that dark cloud is that the central tendency of your inflation forecasts is a tad lower now, at 3 to 3-1/4 percent.

You are generally looking for some pickup in growth next year, with the central tendency of forecasts being 2-1/4 to 2-3/4 percent, to the high side of the staff projection; your price forecasts center on 3 percent, close to our prediction.